

## *Understanding the* **THREE-TIER SYSTEM**

When the 21st Amendment was adopted in 1933, it not only repealed the 18th Amendment, which prohibited the production, transport and sale of alcohol at the federal level, but it also gave states the right to regulate the sale and distribution of alcohol.<sup>1</sup> Shortly thereafter, a new regulatory mechanism known as the three-tier system emerged. This structure was intended to prevent a single company from managing multiple levels of the supply chain (known as vertical integration). It also provided an efficient way to collect state excise taxes and track alcohol through the middle, wholesale tier. Virginia's three-tier system is guided by Code of Virginia 4.1-215, which states Virginia finds it necessary and proper to separate interests between manufacturers, wholesalers and retailers in order to prevent manufacturers from dominating local markets and to prevent excessive alcoholic beverage sales resulting from aggressive marketing techniques.<sup>2</sup>

The three-tier system represents the relationship between **manufacturers, wholesalers and retailers** of alcoholic beverages. The system emphasizes **checks and balances**, allowing states to ensure the process in which alcohol is produced, distributed and sold to consumers is done so in a safe manner. Manufacturers, wholesalers and retailers all have separate, independent roles in the process to make sure alcoholic beverages are checked for safety several times before being purchased by a consumer. Each tier must obtain a license to operate in the state. In general, a single entity cannot hold licenses across more than one tier, however there are exceptions. One exception is that a manufacturer can hold a retail license but cannot sell their products under that license unless both licenses are located contiguous to one another (e.g., brewpubs).

The **Virginia Alcoholic Beverage Control Authority** (Virginia ABC) provides licenses at the manufacturer, wholesaler and retailer levels of the three-tier system. **Manufacturers** include distilleries, breweries and wineries that produce alcoholic beverages. Once beverages are produced by the manufacturer, they are then distributed by **wholesalers**. In Virginia, wine and beer beverages are

distributed by wholesalers with Virginia ABC-issued licenses. Because Virginia is a control state, **Virginia ABC serves as the sole distributor of spirits**, contributing millions of dollars in state revenue each year to the commonwealth's general fund, helping fund education, health and human resources, public safety and more (For more information on control states, see Virginia ABC's "Control State System" white paper).<sup>3</sup> In fiscal year 2021, Virginia ABC provided \$616.4 million to the general fund.<sup>4</sup>

From the wholesaler, alcoholic beverages are then passed to the retailer. **Retail** is the point at which alcoholic beverages can be sold to consumers, as neither manufacturers nor wholesalers are permitted to sell to consumers directly. In Virginia, wine and beer are sold by private retail licensees of Virginia ABC. Spirits are sold either "by the drink" or as samples for on-premises consumption by mixed beverage retail licensees, such as bars and restaurants, or they are also sold "by the bottle" for off-premises consumption by Virginia ABC and Distillery Virginia ABC stores.

## The Three Tier System



Manufacturers → Distributors → Retailers



## *BENEFITS OF THE THREE-TIER SYSTEM*

The three-tier system provides a wide range of benefits, including the protection of alcoholic beverage trade practices to create a **balanced marketplace**. According to the National Alcoholic Beverage Control Association, before Prohibition, one brewery could own every tavern in a city or town, only selling its beers in those establishments.<sup>5</sup> Large manufacturers that could afford distributing and sales costs could run smaller manufacturers who did not have the bandwidth to cover those costs out of business. The current three tier system prevents this form of market domination by applying checks and balances of power with the three-tier system. Other economic benefits include the **assurance of tax collection**. Economists estimate that alcohol taxes generate over \$13 billion in revenue for federal, state and local governments.<sup>6</sup> In Virginia, wholesalers and retailers are mostly small businesses located within the state, making these groups easier to regulate and ensuring that products sold in Virginia pay their share of Virginia taxes.<sup>7</sup>

In addition to a fair economy, the three-tier system also helps promote public health by **preventing excessive alcoholic beverage sales**. Because products are tracked from production to retail sale through the wholesale tier, **the sale of tainted and counterfeit alcohol that can harm the health of consumers is limited in the U.S.** compared to other countries where a three-tier system for alcohol distribution does not exist. For example, three dozen deaths and several serious injuries linked to tainted alcohol were reported in the Czech Republic in 2012, and Honduras, India, Russia, China and the United Kingdom all reported similar occurrences in the early 2010s decade.<sup>8</sup> The three-tier system's regulation on alcoholic products prioritizes public health and safety from the moment an alcoholic product is manufactured to the moment it is sold to a consumer, emphasizing the quality of alcoholic beverages while preventing excessive consumption.



# 80%

*of respondents express support for continuing regulation using a three-tier system according to a 2020 national poll by the Center for Alcohol Policy.*



# \$616.4M

*contributed to the commonwealth's general fund from Virginia ABC sales and taxes during Fiscal Year 2021.*



## *THREATS TO THE THREE-TIER SYSTEM*

There are several threats to the three-tier system, including the **potential for deregulation** of alcoholic beverage production. There is a growing concern that efforts to deregulate alcohol sales in the U.S. will undermine the three-tier system. However, once a person understands the value of the system and the consumer protections it affords to the public, there is widespread support for the system, as evidenced by a national poll conducted by the Center for Alcohol Policy. About 80% of respondents express their support for continuing regulation using a three-tier system, a percentage that has been consistent over the past 10 years.<sup>9</sup> This support for alcohol regulation remains consistent across political party lines, as well; In 2019, 85% of Republicans, 81% of Democrats and 83% of Independents favored alcohol being regulated by the states.<sup>10</sup>

Another threat to the system lies with **craft producers** that are operating within both the manufacturing tier and the retail tier when states permit them to allow for onsite consumption of their products. In other cases, states have permitted craft producers to self-distribute their products, removing the middle, wholesale tier. In Virginia, every manufacturer has a retail privilege; producers can always sell what they manufacture. There are cases where a manufacturer can hold an on-premises or mixed beverage retail license, however the product must be sold on the same property it is manufactured, thus bypassing the wholesale tier. Farm wineries are an exception to the on-site rule, as they can have retail sold off-property and sell wine by another vendor.<sup>11,12</sup>

A third threat to the three-tier system has emerged with the rise of **direct-to-consumer shipping** of alcohol. The process of allowing manufacturers to ship directly to consumers or larger retailers potentially diminishes the profits of both wholesalers and small retailers by shutting them out of marketing activities.<sup>13</sup>

Bypassing the wholesale tier of the three-tier system through direct-to-consumer channels could also lead to fewer checks and balances, undermining the quality controls consumers have long come to expect in the U.S. alcohol marketplace. Further, it can be challenging for small distillers to venture into out-of-state shipping, creating differences in product price, selection and availability for consumers in different states.<sup>14</sup> If a small craft manufacturer cannot find a distributor to take its products to retailers, then that craft manufacturer might not profit, as manufacturers with larger distributors reach more retailers.





## CONCLUSION & REFERENCES

Manufacturers, wholesalers and retailers all work together to ensure quality products for consumers in a balanced market. Although several threats exist, the three-tier system remains a sustainable tool for regulation that is not only supported by the public but is effective in regulating the economy and maintaining public health and safety.

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